Use of Social Impact Bonds to Assist Financially Distressed Municipalities

Over the last several years, there has been a large increase in the number of municipalities filing for protection from creditors under Chapter 9 of the federal Bankruptcy Code—notably Detroit; Jefferson County, Alabama; San Bernardino, Stockton, and Vallejo, California; and Central Falls, Rhode Island; and Harrisburg, Pennsylvania, which attempted to file for Chapter 9, but was rejected. At the same time, there has been increasing interest in a relatively new type of financing mechanism called “social impact bonds.” Query: can the use of social impact bonds be a tool for state, county and local governments to address municipal financial distress?

An Overview of Social Impact Bonds

Impact investing is increasingly recognized by the fields of philanthropy and socially responsible investing as an emerging economy with a powerful potential to leverage investor monies for positive social change. Historically, the federal government has incentivized charitable giving by public and private foundations as well as individuals in the form of tax benefits. With the exception of gifts by charitable corporations, the for-profit sector has, until recently, had relatively few incentives to fund social programming that benefits society’s most challenged members.

Social impact bonds (“SIBs”) are innovative financing tools whereby government partners with investors (for-profit and non-profit) who provide up-front working capital to fund evidence-based social programs that benefit underserved populations. Such performance-based programs are commonly referred to as pay-for-success programs. Although the terms SIBs and pay-for-success are often used interchangeably, SIBs are a mechanism to finance Pay-for-Success programs. SIBs offer philanthropic entities, corporations, financial institutions and others an investment option with the potential to recoup principal (that, in some cases, would have otherwise been a charitable donation) plus earn a return on the investment.

Contingent social impact investing aligns government, social service providers and investors in a common objective by focusing on proven metrics and outcomes that demonstrate creative problem solving of some of society’s most vexing social problems while significantly increasing the efficacy of taxpayer dollars. Under most SIB arrangements, government pays back the principal and a return on investment only if certain pre-defined programmatic milestones have been met, thus transferring risk to the private sector and funding only what works. Government pays for positive outcomes only
after they have actually been achieved, instead of paying up-
front for programs with an uncertain future benefit.

SIBs are significantly different from traditional municipal
bonds. Although SIBs have a fixed term, they do not provide for
a guaranteed rate of return. Repayment to investors is entirely
contingent, outcome-based, and offers only the potential to profit
from the investment. Generally, outcomes demonstrating a larger
social impact pay a higher rate of return.

Intervention programs for vulnerable populations that address
issues such as recidivism, at-risk youth, and low-income
mothers, for example, have been considered the most viable
applications for SIBs. Such programs share five main criteria.
First, the program needs to have a sufficiently high potential
level of social impact so that investors are most likely to realize
their desired return. Second, because investors’ rate of return is
contractually closely correlated to the achievement of certain
outcomes, SIBs will only work for programs whose success
can be determined with precise and verifiable measurements.
Third, the targeted population must be defined up-front, in
order to eliminate the possibility of outcome distortion. For
example, in a program aimed at prisoner recidivism, the cohort
must include all prisoners in a prison community, not just
those receiving services. Fourth, a methodology must exist
whereby social impact can be reliably measured (in addition
to measureable outcomes). Fifth, a contingency plan must be
available, in the case of a failed program, so as not to leave a
vulnerable population stranded if investors want out.

The first SIB was launched in 2010 by the United Kingdom
Ministry of Justice at Peterborough Prison and sought to
decrease rates of recidivism among the prison population.
Now in its fifth year, investors are on track to receive positive
returns in 2016. Since that first experiment, interest in SIBs has
expanded quickly, both in the U.S. and abroad.

A (Very Brief) Overview of Tax-Exempt Bonds

Traditionally, public projects have been financed with
tax-exempt state and municipal bonds, the income from
which is exempt from state and local taxation in the hands of
investors. The tax exemption, however, represents a revenue loss to the
federal government, and therefore Congress and the Treasury
Department have implemented laws and regulations imposing
requirements that make it quite difficult to issue tax-exempt
bonds for projects other than infrastructure, capital projects or
short term cash flow. For example, long term working capital
financings are discouraged and bonds to finance loans are
subject to many restrictions.

How use of SIBs could Assist Financially
Distressed Municipalities

Financially distressed municipalities (in fact, all
municipalities) need higher revenues and lower expenses.
In general, municipalities derive revenues from taxes, fees,
assessments and state aid. Their primary categories of
expenditures are education, public safety and public services,
including services for those in need of public assistance.

One way to increase revenues and decrease expenditures is
to increase family incomes of the chronically unemployed or
underemployed, including young adults. It goes without saying
that higher family incomes would lead to higher income tax
and sales tax revenues at the state level, and in those local
jurisdictions which collect local income taxes and sales taxes,
at the local level as well. In addition, SIBs targeted at programs
to provide training, skills and education opportunities for
the unemployed and underemployed could benefit distressed
municipalities by lowering expenditures for public assistance
and public safety, assuming increased employment also
results in lower incidences of crime. Such targeted programs
could include grants for classes at in-state colleges and junior
colleges, keeping funds at in-state institutions.

Tax-Exempt Status for SIBs?

As stated above, current federal tax law and regulations do not
permit interest on SIBs to be exempt from federal income taxes.
Congress has, from time to time, enacted legislation permitting
certain types of facilities and activities to be financed on a tax-
exempt basis and should consider providing a tax-exemption
on interest income investors receive from SIBs. In contrast to
the federal tax-exemption which would require an amendment
to Internal Revenue Code, state tax exemptions should be quite
simple. In most cases, all that is necessary is a simple statutory
enactment by a state legislature stating that SIBs are exempt
from state taxation. Federal and state tax-exemptions on SIBs
may increase investor appetite and make the social impact
programs financed by SIBs less costly, as investors will be
willing to accept lower rates of return. Social impact investing
is a new type of investing which is still in an evolutionary
stage. States considering SIB legislation, as well as the federal
government, should consider whether beneficial social impacts
will be increased by providing SIBs with an exemption from
taxation at both the state and federal level.